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C O N F I D E N T I A L SECTION 01 OF 03 ASTANA 000817

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TAGS: [ENRG](#) [EPET](#) [KZ](#) [CASC](#)

SUBJECT: KAZAKHSTAN: PETROKAZAKHSTAN LEGAL CASE WINDS DOWN

REF: A. 05 ALMATY 3150

[1](#)B. 05 ALMATY 3857

[1](#)C. ASTANA 90

Classified By: Pol-Econ Chief Deborah Mennuti; reasons 1.5 (b) and (d).

[1](#)1. (C) Summary: On November 14, an Almaty district court convicted three expatriate former executives (two AmCits) of PetroKazakhstan (PK) of criminal violations of Kazakhstan's anti-monopoly law. The judge simultaneously granted the defendants amnesty and lifted a travel ban that had been in place since the criminal charges were filed in April 2005. The only AmCit defendant remaining in Kazakhstan, Tom Dvorak, plans to depart Kazakhstan on December 17.

[1](#)2. (C) Summary (continued): PK's controversial October 2005 sale to the Chinese National Petroleum Company (CNPC) recently came two steps closer to closure, as Kazakhstan's national oil and gas company, KazMunaiGaz (KMG), finalized a deal on November 16 to purchase 50% of PK's Shymkent refinery; and Lukoil won an October 30 arbitration ruling granting it a preemptive right to acquire PK's half of the Turgai oil field (at the price paid by CNPC). An argument can be made that the legal case of the PK executives was manipulated to enhance the GOK's leverage in its post-sale negotiations with CNPC to acquire a share of the PK assets. While PK's ten-year experience in Kazakhstan has arguably been unique, it nevertheless offers several perspectives from which to evaluate Kazakhstan's investment climate. End summary.

PK Executives Convicted -- and Amnestied  
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[1](#)3. (C) On November 14, after an intermittent 8-month trial, an Almaty district court convicted three former expatriate executives of the Canadian oil company PetroKazakhstan (PK) of criminal violations of the anti-monopoly law, sentencing them to three years' imprisonment. (In addition to the two American citizens, Tom Dvorak and Robert Goldsmith, and a Canadian, Clayton Clift, the court also convicted twelve Kazakhstani PK employees.) All the PK employees were then granted amnesty under a January 2006 "Independence Day" Amnesty Law, and the court lifted a travel ban in place since April 2005. (Note: Of the three expatriates, only Dvorak remained in Kazakhstan through the trial's end. Dvorak told Econoff on November 29 that he plans to leave Kazakhstan on December 17. End note.) The defendants have appealed the conviction.

[1](#)4. (SBU) Note: Another AmCit PK employee, Dan Hermann, was granted amnesty in January 2006 in what was, legally, an

unrelated case. Hermann was charged with violating the terms of PK's exploration license (Ref A).

#### Origin of the Criminal Charges

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15. (SBU) The criminal charges stem from activities PK undertook, beginning in 2002, to sell refined products from PK's Shymkent refinery at prices higher than those established by Kazakhstan's Agency for the Regulation of Natural Monopolies. PK executives attempted to avoid the application of the Monopoly Law by dividing the sales of its refined products, previously undertaken by a single business entity, among seven newly-created companies. Each of the seven companies allegedly managed the volumes of its regional sales, selling into one another's respective regions, to avoid establishing the 35% market share required to apply the monopoly price ceilings.

16. (C) Dvorak told Econoff on November 29 that, notwithstanding the conviction, the Procurator's case "was full of holes." One example, he explained, was the fact that he, Dvorak, did not even begin working for PK until August 2003, and thus could hardly have contributed to the alleged "conspiracy" begun in 2002 to evade the law. Further, he argued, the refinery's privatization agreement, drafted in the late 1990's when the State first sold its interest in the refinery, guaranteed that the refinery's products would not be subject to future price controls. And finally, Dvorak said, the Procurator had never established in court that PK's distribution scheme had resulted in higher prices for the refined products.

17. (C/NF) However, Dvorak admitted, in retrospect PK "clearly should have done things differently." The defendants' case

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had been undermined, he noted, by the exposure of an internal memo, written by PK's lawyers, warning that creating the new distribution companies would make the company vulnerable to charges of anti-monopoly violations.

#### "Why Us?" -- Making Sense of the Past

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18. (C/NF) In seeking to explain the cause ("why us?") of their legal problems, the PK executives have favored different hypotheses at different times. Prior to the company's announced sale to CNPC, Dvorak and Goldsmith often defended the thesis that PK's legal problems were the result of a GOK plot (perhaps in collusion with Lukoil) to drive down PK's share price prior to a planned bid to buy the company. According to this theory, KMG had long coveted the Shymkent refinery. Dvorak and Goldsmith tended to see most of the company's legal problems in this light, including several legal disputes with its joint venture partner Lukoil, and the GOK's enforcement of gas flaring restrictions which forced a 30% cut in PK's 2005 oil production.

19. (C/NF) Following the announcement of PK's sale to CNPC, Goldsmith and Dvorak found hope that the legal case against them would be dropped -- after all, as they argued at the time, there was no further reason for the GOK to target PK's stock price. As the legal case against them moved forward, however, they adopted a different hypothesis: that the GOK, taken by surprise by the sale, was using the legal case as leverage in post-sale negotiations to acquire key PK assets from the Chinese. (Note: Much evidence points to the fact that the GOK was caught unprepared by the sale, the most dramatic of which was a series of amendments which the GOK rushed into law before the deal was finalized (Ref B), which extended the GOK's "preemptive rights" and thus strengthened its negotiating position with CNPC. A KazMunaiGaz (KMG) contact told us at the time that the GOK had been unpleasantly surprised by the high price paid by CNPC -- a price KMG would have to match, under the preemptive right

legislation, to acquire the PK assets. End note.)

#### Refusing Amnesty and Other Legal Oddities

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¶10. (C) The guilt or innocence of the executives aside, the anti-monopoly case took more than one questionable turn in the Winter and Spring of 2005-06, which fed the executives' sense that they were pawns in a bigger game. The most curious of these was the Procurator's refusal to apply the Amnesty Law in January and February 2006, before the case went to trial, despite PK's repeated legal appeals and Embassy requests for close consideration. (The Embassy also voiced concern about the tendency, present both in this case and in recent AES disputes, of the authorities to file criminal charges in what are essentially civil cases.) In Spring 2006, the trial judge also refused, during pre-trial motions, to dismiss the case on the basis of the amnesty -- only to do so at trial's end.

¶11. (C/NF) As further evidence that his case was being manipulated for larger purposes, Dvorak cites the fact that the list of alleged victims of PK's "monopolistic" activities -- companies which allegedly overpaid for refined products -- grew in apparent synchrony with the reported intensity of the GOK's negotiations with CNPC. (The dollar amount of these alleged damages reached, at one point, approximately \$750 million, before shrinking throughout the summer of 2006, under examination of the court, to approximately \$55 million.

These damages represent PK liabilities which CNPC legally assumed upon purchasing the company. Dvorak, who remained on PK's payroll even after the company's sale to CNPC, told Econoff that this (inflated) dollar figure was being used as a bargaining chip in the GOK-CNPC negotiations.) Dvorak also asserts that the list of alleged victims of the crime was populated by numerous brand-new companies created, presumably, in order to file claims and make a buck from PK's legal problems. PK's lawyers, Dvorak claims, were able to establish that fourteen of the allegedly unrelated victimized companies, in fact, shared a single bank account. Dvorak believes that the courts may have refused to grant amnesty in January 2006 in order to allow these "victimized" companies the opportunity to collect in court. (In denying application of the Amnesty Law, the Procurator's office cited a need to gain the consent of all injured parties before applying the amnesty.) And, finally, Dvorak believes that his own conviction may have been "necessary" as evidence in the ongoing legal case to collect the \$55 million from CNPC.

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¶12. (C/NF) Comment: While it is easy to blame Kazakhstan's weak judicial system for many of the recent legal cases involving Western investors -- and we readily do so, here, in the instance of the non-applied amnesty -- it is worth pointing out that companies take on different level of "legal risk," by virtue of adopting conservative or aggressive legal and accounting practices, just as they take on differing levels of financial risk in making their investments. PetroKazakhstan, it appears to us, may have pushed the legal envelope. Even without taking a hard position on the justice of the anti-monopoly verdict, however, we clearly decry one of the more insidious aspects of the current investment climate in Kazakhstan -- the discretion of authorities to file criminal charges in cases which are essentially civil in nature, without meeting Western standards for establishing criminal intent.

¶13. (C) Comment (continued): With the recent sale of PK and Nelson Resources, the ongoing CITIC bid to buy NationsEnergy (Ref C), and growing rumors of a Chinese bid for MangistauMunaiGas, we may be witnessing the end of the ownership of Kazakhstan's mid-sized oil fields by private investors and mid-sized foreign companies. As these investors move out, cashing in on high oil prices, KMG is likely to exercise its preemptive rights to take a share of

the assets, thus expanding its onshore presence in parallel with its legislatively-prescribed requirement to take part in all offshore projects. Perhaps paradoxically, KMG's growing presence is likely to improve the investment climate for project partners. As KMG's Kashagan partners tell us, having KMG as a partner is helpful when addressing legal or fiscal issues raised by the GOK. While KMG's new role, onshore and off, is usually seen as a means to develop the national company, and gradually expand State ownership and control over Kazakhstan's hydrocarbon reserves, it may also serve as means to institutionalize, and thus tame, the "Wild West" characteristics of Kazakhstan's oil patch. End comment.

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